

# Regionalism versus Multilateralism

*L. Alan Winters*

Do the forces that regional  
integration arrangements set  
up encourage or discourage  
a trend toward globally freer  
trade? We don't know yet.

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## Summary findings

The literature on regionalism versus multilateralism is growing as economists and political scientists grapple with the question of whether regional integration arrangements are good or bad for the multilateral system. Are regional integration arrangements “building blocks or stumbling blocks,” in Jagdish Bhagwati’s phrase, or stepping stones toward multilateralism? As economists worry about the ability of the World Trade Organization to maintain the GATT’s unsteady yet distinct momentum toward liberalism, and as they contemplate the emergence of world-scale regional integration arrangements (the EU, NAFTA, FTAA, APEC, and, possibly, TAFTA), the question has never been more pressing.

Winters switches the focus from the immediate consequences of regionalism for the economic welfare of the integrating partners to the question of whether it sets up forces that encourage or discourage evolution toward globally freer trade. The answer is, “We don’t know yet.” One can build models that suggest either conclusion, but these models are still so abstract that they should be viewed as parables rather than sources of testable predictions.

Winters offers conclusions about research strategy as well as about the world we live in. Among the conclusions he reaches:

- Since we value multilateralism, we had better work out what it means and, if it means different things to different people, make sure to identify the sense in which we are using the term.
- Sector-specific lobbies are a danger if regionalism is permitted because they tend to stop blocs from moving all the way to global free trade. In the presence of lobbies, trade diversion is good politics even if it is bad economics.
- Regionalism’s direct effect on multilateralism is important, but possibly more so is the indirect effect it has by changing the ways in which groups of countries interact and respond to shocks in the world economy.
- Regionalism, by allowing stronger internalization of the gains from trade liberalization, seems likely to facilitate freer trade when it is initially highly restricted.
- The possibility of regionalism probably increases the risks of catastrophe in the trading system. The insurance incentives for joining regional arrangements and the existence of “shiftable externalities” both lead to such a conclusion. So too does the view that regionalism is a means to bring trade partners to the multilateral negotiating table because it is essentially coercive. Using regionalism for this purpose may have been an effective strategy, but it is also risky.

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## **Regionalism versus Multilateralism**

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This paper was prepared for a CEPR Conference on Regional Integration, La Coruña, Spain, April 26-27, 1996, and will appear in the conference proceedings. I am grateful to Anju Kapur for research assistance, to conference participants and to Richard Baldwin, Will Martin, Pier Carlo Padoan and André Sapir for comments on an earlier draft, and to Audrey Kitson-Walters for logistical support.



## 1. Introduction

The literature on “regionalism vs. multilateralism” is burgeoning as economists and a few political scientists grapple with the question of whether regional integration arrangements (RIAs) are good or bad for the multilateral system as a whole. Are RIAs “building blocks or stumbling blocks,” in Bhagwati’s (1991) memorable phrase, or stepping stones towards multilateralism? As we worry about the ability of the WTO to maintain the GATT’s unsteady yet distinct momentum towards liberalism, and as we contemplate the emergence of world-scale RIAs--the EU, NAFTA, FTAA, APEC and, possibly, TAFTA--this question has never been more pressing.

“Regionalism vs. multilateralism” switches the focus of research from the immediate consequences of regionalism for the economic welfare of the integrating partners to the question of whether it sets up forces which encourage or discourage evolution towards globally freer trade. The answer is “we don’t know yet.” One can build models that suggest either conclusion but to date these are sufficiently abstract that they should be viewed as parables rather than sources of testable predictions.

Moreover, even if we had testable predictions we have very little evidence. Arguably the European Union is the only RIA that is both big enough to affect the multilateral system and long-enough lived to have currently observable consequences. The EU allows one convincingly to reject the hypothesis that one act of regionalism necessarily leads to the collapse of the multilateral system. But it is difficult to go further: the *anti-monde* to EU creation is unknown and one does not know to what extent the EU is special.

Thus any discussion of the evidence is necessarily judgmental. The majority view is, I think, that the advent of the EU aided multilateralism. While I should like to believe this-- especially now that US commitment to multilateralism is diluted by other “lateralisms” (Summers, 1991)-- more needs to be done before it can be considered proven beyond reasonable doubt.

This paper has three substantive sections. Section 2 tries to define some terms, which turns out to be much more complicated than I expected: any reader who can define multilateralism simply can skip Section 2.1 and let me know his or her definition. It also proposes an organizational classification for models of “regionalism vs. multilateralism.” Section 3 discusses these models under five headings and Section 4 discusses some evidence. Section 5 offers some conclusions.

Survey articles are sometimes used to resolve issues of intellectual precedence. I have not sought to do this and would caution against using the dates of the papers included here as a means of doing so. In a field barely five years old, publication delays completely distort the time picture.

## **2. Definitions and Classifications**

### **2.1 Definitions**

“Regionalism vs. Multilateralism” is a much discussed topic among trade economists, but one which is surprisingly short on precise measures. I shall define “regionalism” loosely as any policy designed to reduce trade barriers between a subset of

countries regardless of whether those countries are actually contiguous or even close to each other. I shall not define “multilateralism” precisely, however, because--to my surprise and regret--I find that I cannot easily do so.

Although multilateralism is a characteristic of the world economy or world economic system, it must ultimately reside in the behavior of individual countries--the extent to which they behave in a multilateral fashion. For any one country I shall treat the latter as a positive function of

(a) the degree to which discrimination is absent--perhaps the proportion of trade partners that receive identical treatment; and

(b) the extent to which the country’s trading regime approximates free trade.

Strictly speaking (a) would seem to be a sufficient definition of multilateralism. However, it is neither very interesting in the current context (any preferential trade arrangement with relatively few members will worsen multilateralism), nor, I infer from their writings, what most commentators have in mind when they debate the effects of regionalism on multilateralism. Criterion (b) attempts to add back the missing dimension.

The weights and functional form with which the two criteria enter the index of individual multilateralism are left vague. If, starting from a universal (mfn) tariff, a country abolished tariffs on one (small) partner, that would seem to decrease its multilateralism, but if it abolished them on all but one (small) partner that would seem to increase it.<sup>1</sup> Similarly I

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<sup>1</sup> Appendix 1 offers a little more detail on such an index.

cannot pin down precisely how to combine countries into a single global index of multilateralism. Thus we need to be cautious in comparing different views of “regionalism vs. multilateralism”--maybe their bottom lines differ.

In assessing regionalism we need also to recognize another complication. Shifting one partner into an FTA has a direct impact on our measure of multilateralism, but, far more importantly, it also potentially initiates a whole series of accommodating adjustments, as the integrating partners and countries in the rest of the world (RoW) adjust their policies to the new circumstances. We must consider multilateralism at the end of this process not just at the beginning. Moreover, in some circumstances the final outcome will not be determinate; rather, regionalism might affect the probabilities with which different outcomes occur. Several of the models surveyed below examine whether regionalism makes it more or less likely that countries within and without the RIA can strike a deal to create or maintain worldwide free trade. Such models do not forecast particular outcomes but nonetheless comment pertinently on the environment in which they might flourish.

The previous paragraph mentioned a “process.” Multilateralism is sometimes referred to as a process whereby countries solve problems in an interactive and cooperative fashion (Yarbrough and Yarbrough, 1992). While such interactions could clearly be affected by regionalism, I do not use this definition here. It is a view far too closely associated with professional negotiators and international bureaucrats for my taste, and is far too vague on the question of what purpose process serves if it is not to generate outcomes.



Other commentators might focus entirely on the final outcome--the pattern of international trade. If one could determine the perfectly multilateral volume and pattern of trade, one could then easily define the index of actual multilateralism by any of several distance measures between actual and “perfect” trade. The problem is all too obvious, however: how do we determine perfectly multilateral trade? From a policy point of view I should also be uneasy about a definition that focused on outcomes rather than trade policy instruments, for such a definition might imply indifference between methods of achieving particular trade patterns. I recognize, however, that such unease should not influence us too much in the intellectual business of defining the phenomenon.

Finally, many economists explore the interactions between countries and the effects of regionalism on them by focusing on country welfare, and, usually, world welfare. These contributions are not strictly about regionalism versus multilateralism, for we surely cannot define multilateralism in terms of increasing welfare--even if, slightly less indefensibly, we sometimes equate them. Nonetheless, welfare is sufficiently basic to the business of economics that I include this class of studies in this survey.

## **2.2 A classification**

To try to organize the rapidly growing model-based literature on “regionalism vs. multilateralism,” I have classified contributions according to four characteristics of their basic approach. These concern political objectives and organization rather than economics *per se*, for, in fact, most models adopt one of two main representations of the economy: the simple competitive homogeneous good model or the monopolistically competitive model.

In each there is usually a one-to-one correspondence between goods and geographical entities--each entity having comparative advantage in one good--but in the latter several entities--say, provinces--accrete into one country. The four characteristics are:

(A) Is the objective function (1) national economic welfare or (2) some other criterion deriving from political considerations? Within the latter set, (2), does the analysis explicitly treat (i) one country, (ii) two (i.e., the partners) or (iii) three-plus (the partners and the RoW)?

(B) Is the model (1) symmetric or (2) asymmetric, the former entailing that the model deals only with circumstances in which all blocs are qualitatively identical? Within the latter set, I distinguish models which consider (i) only the integrating blocs, (ii) only the non-member countries (which are candidates for accession), or (iii) both.

(C) Is the interaction between countries (1) one-off or (2) repeated? The latter is operationalized (universally, I believe) in the form of trigger strategies.

(D) Is the aggregation of preferences or behavior in the post-integration bloc (1) implicit--by far the more common assumption--or (2) explicit? While dimension (A<sub>2</sub>) considers the roles of groups and interests as they affect each of the governments involved in the integration, this dimension (D<sub>2</sub>) explicitly focuses on the interactions between pressure groups and between governments within the bloc when it comes to making post-integration decisions.

It is not possible to find examples of work in each of the 64 boxes that this classification defines. Equally, many authors offer examples in several boxes, and in a survey of this length one cannot enumerate all of these explicitly. Rather I locate studies according to their principal insights or those of the stream of literature to which they belong. Section 3 is based loosely on the classification. It starts with the conceptually simple symmetric welfare-maximizing models ( $A_1, B_1, C_1, D_1$ ) and then moves on to asymmetric models ( $A_1, B_2, C_1, D_1$ ). Sub-section 3.3 deals with models of negotiated tariffs ( $A_1, B_1$  or  $B_2, C_2, D_1$ ) and 3.4 with models of political economy ( $A_2$ ). Finally, I consider models of the institutional structure of policy-making within an integrated bloc ( $D_2$ ).

### **3. Models of Tariff Regimes**

#### **3.1 Symmetric models**

While the consistency of regional trading arrangements with the multilateral trading system had attracted some debate previously and had, indeed, been modeled formally, the subject took off with a seminal article by Paul Krugman (1991a).<sup>2</sup> This considers a simple model of integration and trade policy in which there are  $N$  identical countries and  $B$  identical blocs. Each country produces one product; these are differentiated symmetrically from all others and all consumers consume all goods (Dixit & Stiglitz differentiation); there are no transport costs, but each country levies a tariff on imports from all non-partner countries. When  $B=N$  each country is a bloc, but as  $B$  falls (with  $N/B$  taking integer values) the countries within each bloc offer each other free market access and levy a common tariff on

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<sup>2</sup> Earlier contributions include Reizman (1985) and Kennan and Reizman (1990).

all non-partners. Within each country some products are available tariff-free--domestic and partner supplies--while all others face an identical tariff,  $t$ . Tariffs are set to maximize bloc welfare given the tariffs charged elsewhere in the world--a traditional Nash optimum tariff game.

Krugman shows that as the number of blocs in the world decreases (that is, as integration occurs) each bloc's share in the other blocs' consumption rises, conferring more market power on each and raising the optimum tariff. Integration creates trade diversion but in this model it is exacerbated by raising the external tariff. Krugman (1993) shows that the effect of the latter on economic welfare is relatively weak, however, and that even if it is suppressed his main conclusion continues to hold. The latter is that the pessimum number of blocs in terms of welfare is very small--three for most of his examples.

Krugman (1993) disaggregates the causes of the welfare losses from regionalism and finds that they owe far more to trade diversion than to increases in the optimum tariff. That is, the first-order impact of what countries do to themselves through regionalism matters more than the second-order interactions between countries. This is a useful lesson when considering any trade policy, but it is particularly salutary for our discussion, reminding us that multilateralism is not the only dimension of relevance. According to the imperfect index developed above, regionalism with a fixed external tariff may or may not harm multilateralism *ceteris paribus* --see figure A.1--but the act of raising the external tariff certainly does.

Krugman's work stimulated a storm of criticism and extension. The most pressing theoretical criticism was that his production structure contained no element of comparative advantage, and that this led him to over-emphasize trade diversion. Srinivasan (1993) offers one counter-example and Deardorff and Stern (1994) another; the latter have equal numbers of two kinds of country in the world and show that blocs containing equal numbers of each type realize the full benefits of free trade regardless of their external trade policies. Thus the latter become irrelevant.

A more sophisticated alternative is to be found in Bond and Syropoulos (1996a), who introduce comparative advantage in an elegant way. Each country has an equal endowment of all goods plus a supplementary amount (positive and negative) of one of them; the relative size of the supplement and the regular endowment represents the degree of comparative advantage. Working with a lower elasticity of substitution than Krugman, Bond and Syropoulos find that optimum tariffs can fall as bloc size increases symmetrically. The world welfare-minimizing number of blocs is two if comparative advantage comprises having more of one good than others, but may be three or even higher if it comprises having less of only one. Thus the Krugman result, and, indeed, the effect of regionalism on multilateralism, is obviously sensitive to issues of comparative advantage.

Sinclair and Vines (1995) reproduce Bond and Syropoulos's result about the possibility of a falling optimum tariff as the number of blocs decreases, but in slightly more general circumstances--CES preferences (as in Krugman) rather than Cobb-Douglas. They also relate it to another important qualification. Krugman and most of his successors in this

literature consider the creation of customs unions (CUs), which can increase tariffs above pre-integration levels because, by coordinating several countries' policies, they can exert more market power than any individual country. If the integration takes the form of free trade areas, however, countries retain control of their own tariffs on the RoW and these will fall as regionalism proceeds. As more and more partners receive tariff-free access to one country's market the smaller becomes the set of goods subject to the tariff and thus the more distortionary the effect of a given tariff. Thus the incentive arises to cut the tariff in order to achieve better balance in the composition of imports--through what Sinclair and Vines call the "optimal import-sourcing condition."

The optimal import-sourcing condition also helps to explain why the optimal tariff for a CU might fall as the union enlarges. If countries have rather similar endowments,<sup>3</sup> they trade rather small proportions of their output and income and hence have rather little monopsony power over each other. Thus the optimal import allocation condition which promotes equal tariffs across partners (equal to zero if some tariffs are constrained by regional arrangements) can overcome the increased monopsony power arising from larger bloc size which tends to raise the tariff on the RoW. Krugman has wholly different endowments across countries and hence for him the monopsony effect always dominates.

An important extension of Krugman's model is to recognize the role of transport costs. Krugman was the first to do this, in Krugman (1991b), but the issue has been most

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<sup>3</sup> Sinclair and Vines model the similarity somewhat differently from Bond and Syropoulos.

thoroughly taken up by Frankel, Stein and Wei in a series of papers.<sup>4</sup> Krugman (1991b) subdivided the world into continents and observed that if inter-continental trading costs were infinite--thus precluding inter-continental trade--a series of regional blocs each covering one continent would produce a first-best outcome equivalent to global free trade.<sup>5</sup> Krugman inferred a notion of “natural blocs” from this--blocs for which low trade costs made regionalism a natural and beneficial policy.

Frankel, Stein and Wei (1995, 1996) and Frankel (1996) fill in the middle ground between the two Krugman views by allowing transport costs to be finite but non-zero. As might be expected they find that, as inter-continental transportation and business costs increase relative to intra-continental ones, regionalism becomes a better policy in welfare terms. For a particular parameter constellation (three continents each with two countries, tariffs of 30%, an elasticity of substitution between varieties of four, and zero intra-continental trading costs) they find that if inter-continental costs absorb above 15% of the gross value of an export, intra-continental regionalism is welfare-improving. This result is interesting, but not very robust. Frankel, Stein and Wei themselves quote contrary results and Nitsch (1996a) shows that just raising intra-continental costs to 5% in the case above, means that regional blocs are welfare-improving for all values of inter-continental costs. Inter-continental regionalism (i.e., blocs between countries in different continents) is always

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<sup>4</sup> They refer to their discussion as “Krugman vs. Krugman,” my nomination for title of the year.

<sup>5</sup> Deardorff and Stern (1994) effectively use the same approach but pairing countries by complementary comparative advantage rather than transportation costs. Arguably, however, their results gravitate away from continental blocs rather than towards them if comparative advantage varies more across continents than within them.

harmful for Frankel Stein and Wei, although as inter-continental costs rise it becomes less so because it affects less and less trade. This result has also been challenged by Nitsch (1996b) who gives examples with relatively low inter-continental transport costs in which “unnatural” integration dominates “natural” integration!

Frankel et al also consider preferential trading areas which merely reduce rather than abolish tariffs between partners. Preferential areas can always be constructed to be welfare improving--essentially because they ensure that the optimal import-sourcing condition is not too badly violated. In this sense Frankel et al argue that bloc-formation is a stepping stone towards multilateral free trade, but since there is no mechanism through which the benign path is ensured or even encouraged this does not seem a particularly powerful characterization to me. Merely referring to the welfare benefits is not sufficient, for one could equally well refer to the (greater) benefits of jumping straight to free trade.<sup>6</sup> I shall not pursue this (GATT-proscribed) analysis of preferential trading blocs further. It seems to me seriously flawed on the political economy grounds that potentially it completely undermines the mfn clause (which could easily prevent multilateral progress towards liberalization) and encourages too much trade activism.

A further wrinkle on the Frankel model is provided by Spillembergo and Stein (1995) who introduce trade based on comparative advantage in addition to Krugman's and Frankel's basic intra-industry variety. If inter-continental trading costs are very low

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<sup>6</sup> Similar arguments surround the Kemp and Wan (1976) result that a customs union can always find a common external tariff that renders it welfare improving and thus that unions can beneficially expand and combine until they arrive at global free trade. “Can,” but there is no analysis of “do.” This is not to criticize Kemp and Wan; their focus was not on stepping stones.



Spillembergo and Stein replicate the results above--i.e., Krugman's (1991a) "anti-bloc" result if variety effects are strong, and welfare increasing with the size of blocs (and thus their fewness) if these effects are weak. With moderate inter-continental costs, on the other hand, Spillembergo and Stein replicate Frankel, Stein and Wei. This model is the current encompassing model for CUs--all the above discussion is, at least loosely speaking, a special case of Spillembergo and Stein.

For completeness I mention one final symmetric welfare-maximizing model which suggests that regionalism can provide stepping stones to multilateralism within a somewhat unconventional framework. Collie (1995) considers countries each with a constant returns to scale sector and one differentiated good sector. The latter compete in a third market and receive export subsidies as in the traditional strategic trade policy story. Integration between these countries allows--and encourages--better coordination of export subsidies and hence reduces distortions and raises welfare. This effect continues as bloc size grows until all the (producing) countries are integrated. This is not a particularly persuasive model, however, for the CRS sectors do not change their level of integration, export subsidies are not the instrument of concern in regionalism and there is, in this model, no incentive for any country to join a bloc. For these reasons, Collie's is not a convincing refutation of the concerns that regionalism undermines multilateralism.

### **3.2 Asymmetric models**

A feature of all the results discussed so far is that regionalism is always symmetric in the sense that as bloc size increases countries recombine into groups of equal size. This is a

useful simplification for asking what are the effects of having bloc size  $B_1$  in the world economy and how such effects compare with those of having bloc size  $B_2$  in an otherwise identical world. But there is no sense of evolution or expansion in such a static setup and this severely limits the light they can shed on the issue of whether regionalism might *lead to* multilateralism. I turn now, therefore, to models in which blocs grow endogenously and thus which at some stage are asymmetric.

Bond and Syropoulos (1996a) make a start in the required direction by allowing their blocs to expand asymmetrically. Starting from a symmetric equilibrium, they show that a bloc would gain by admitting new members drawn equally from each of the other blocs. The terms of trade benefits of boosting demand for the bloc's comparative advantage goods would outweigh the trade diversionary effects in this model, even if the enlarged bloc did not increase its tariff on other countries. Second, Bond and Syropoulos ask what bloc size maximizes member countries' welfare given that other countries levy optimum tariffs. The answer is large but not the whole world, for the benefits depend on terms of trade gains which are obviously missing if the bloc contains all countries.

Frankel (1996) also sheds a little light on this issue. In a world of four continents the countries of which initially practice mfn trade policy, he shows that a sequential Nash game leads to regionalism and lower welfare for all. (This does, of course, depend on parameter values.) Specifically, one continent (any one, since all are identical) can improve its welfare by creating an FTA, assuming that the other three keep their mfn tariffs. These three lose because, even absent the bloc increasing its tariff, their terms of trade decline. From here a

second continent benefits itself by integrating, assuming unchanged policies elsewhere, and thence the third and fourth continents. In the end all are worse off than under mfn policies, but none has the incentive to undo the regionalism. Whether the process then continues to create two inter-continental blocs, however, Frankel does not say, but at least for a variety of parameter values this does not seem likely since inter-continental blocs have previously been shown not to be desirable.

Very similar results were derived by Goto and Hamada (1995a, b) using a Krugman (1993)-type model with four countries.<sup>7</sup> They too found a scenario in which one regional bloc begat another but in which the two “superblocs” then had an incentive to combine in order to achieve global free trade. More sinisterly, however, they also showed that once *A* and *B* had combined into a bloc it would pay them to pre-empt *C* and *D*’s combining similarly, by bringing one of the latter into their own bloc. Of course, this would impose high costs on the country that was left out, but unless the other three acquiesced this country could do nothing about achieving freer trade. In detail this result just reflects an overly powerful terminal condition to an *N* country game--the last country is always powerless. In more realistic circumstances the superbloc excludes more than one country and these countries would then have an incentive to create their own bloc. The insight that integrators may veto indefinite bloc expansion is real enough, however.

Nordstrom (1995) discusses these issues in a slightly more general framework, although at the cost of having to simulate his model rather than solve it analytically.

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<sup>7</sup> That is, blocs do not raise their optimum tariffs as a result of integration.

Nordstrom starts with a model very similar to that of Frankel and his collaborators--with product differentiation and finite transport costs. He starts by considering just one bloc--a customs union (CU). Its creation and expansion harm excluded countries even at constant external tariffs; but in mitigation, these countries can always raise their welfare above free trade levels by joining the bloc and "exploiting" further the remaining outsiders. As suggested by Goto and Hamada and by Bond and Syropoulos, however, this process does not lead to the so-called global coalition (all countries within the CU), because existing members will eventually lose from further growth as the set of outsiders to exploit declines. Nordstrom suggests that after about half the countries are inside the CU, further growth will be vetoed from the inside.

Nordstrom observes that if the CU chooses an optimum tariff rather than a constant one, it will increase its tariff as it grows, hitting outsiders harder than in the previous example. Then, in the absence of retaliation, the optimum size of the union is about 60% of the world economy. But, of course, the excluded countries might retaliate against such aggression. If they alter their mfn tariffs so that they are punishing each other as well as the CU, there is little they can do, but if they maintain tariffs against each other and coordinate their punishment tariff against the CU they can exercise significant market power. Such retaliation could reduce the CU's welfare below what it could achieve at a constant external tariff (and no retaliation) if it is smaller than about 75% of countries.<sup>8</sup> A CU of more than 75% of countries would win the tariff war even in the face of coordinated opposition.

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<sup>8</sup> An alternative strategy would be for the union to reduce its tariff to keep non-member welfare constant--a so-called Kemp-Wan reduction. The union would prefer this to trade war if it had below about 40% of countries.

The implication of all this for “regionalism vs. multilateralism” is ambiguous. The assumed form of retaliation effectively transforms the excluded countries into a second CU, albeit one with non-zero internal tariffs. This raises the possibility that the two blocs could gain jointly from cooperation. However, in this model there is no identified way out of their prisoner’s dilemma: the issue is not addressed. The threat of retaliation if the union raises its tariffs does nothing to prevent the creation of the union, it just limits its behavior once formed.

Nordstrom explores inter-bloc issues more formally by breaking his world into two “continents”-- $A$  and  $B$ --and allowing blocs in each--very similar to the approach taken by Frankel et al. Nordstrom finds that a CU on continent  $A$  hurts all excluded countries, but impinges much more heavily on those in  $A$ , which are the CU’s “natural” trading partners, than on those in  $B$ . The incentives are for both sets of countries to seek integration; as previously, the CU in  $A$  may close its doors, but nothing can stop a CU forming in  $B$ . However, if there is the prospect that after the formation of blocs on both continents an inter-bloc negotiation will take place, the blocs seem likely to include all the countries on their continents in order to maximize their power in this second round. Then, provided the continents are not of very disparate sizes, negotiation of inter-bloc free trade would be mutually advantageous.

If one couples the previous paragraph with an argument that countries operating independently would not be able to negotiate global free trade, and if one is lucky with the relative sizes, Nordstrom’s results are very favorable to regionalism. Starting from mfn

tariffs a local CU forms; it is matched elsewhere in the world; both CUs expand to increase their bargaining power and then ultimately they negotiate global free trade.

Clearly there are many points at which this rosy scenario could break down. One, noted almost *en passant* by Perroni and Whalley (1994), arises because one can interpret the anxiety of small countries to join large neighboring blocs as seeking insurance--a desire not to be left isolated if global trade war breaks out. Small countries pay for the privilege of belonging to a bloc by offering up their markets preferentially.<sup>9</sup> Insurance premia are higher the more uncertain the world and the costs of errors are lower if one is insured: in other words, the large powers may gain from sabre-rattling while small countries are deciding whether to join them, and after they have joined, the small countries will be less concerned to preserve a global system than previously. Since sabre-rattling is effective only if there is some chance of violence, this makes the possibility of regionalism look quite hostile to multilateralism.

Finally, again for completeness, I note an interesting model of a quite different nature in which regionalism is benign and welfare increases monotonically with bloc size. No country has any special characteristics, but the model is asymmetric in allowing for the formation of any coalition to block global free trade. In Kowalczyk and Sjostrom (1994) countries have monopolies in their own export goods and exploit each other by charging monopoly prices. The only policy variables in use are import price ceilings, although equivalent results would arise if import subsidies were used. Integration entails agreeing to

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<sup>9</sup> As Perroni and Whalley observe, in strict trade-policy terms Eastern Europe, the Mediterranean countries and Mexico gain little from their associations with larger blocs relative to unilateral mfn liberalization.

use ceilings to force firms to price exports at marginal cost in partners' markets--i.e., it entails moving from free trade to intervention (!). The details of preferences and cost functions ensure that excluded countries are quite unaffected by such integration. In this world identical or nearly identical countries that behaved rationally would find their way to global integration. If countries differed strongly, however, coalitions could arise that block this evolution, because they would find it more advantageous to exploit certain other countries. In these cases, however, a system of side payments could be devised to achieve the first-best optimum. While Kowalczyk and Sjoström's model is very stylized, it does suggest that regionalism may not lead to multilateralism and that this may be because global institutional structure cannot support mechanisms for side-payments.

A significant criticism of the work surveyed so far is that tariffs and other forms of protection are determined not by optimal tariff considerations but rather by domestic political processes mitigated by international negotiation. This is true, but the simple models are still useful in illustrating the spillovers and interactions between countries and in identifying threat points for various negotiating games. Moreover, the apparently related criticism--that GATT's Article XXIV prevents integrating countries from raising their tariffs--is not particularly powerful. Article XXIV has been notable for its weak enforcement so far; many trade policies have been unbound under the GATT and hence free of constraint; there are several GATT-consistent policies of protection--e.g., antidumping; and in a world of trend liberalization, merely going more slowly than you otherwise would is essentially a form of increased protection. For these reasons I am not unhappy with models that take seriously the threat that blocs could raise barriers. On the other hand, the

implications of strictly optimal tariffs (e.g., indifference to changes in trade volumes) are uncomfortable and generalizations would be welcome. The rest of this part of the paper therefore considers a broader set of models starting by recognizing the importance of negotiations.

### **3.3 Negotiated tariffs**

An early and elegant step in the direction of incorporating trade agreements into the analysis of regionalism is Bond and Syropoulos (1996b). Using the same basic model as Bond and Syropoulos (1996a), they consider trigger strategies such that initially there is inter-bloc free trade supported by the threat of perpetual trade war if any party breaks the agreement. They then ask what rate of discount just leaves blocs indifferent between defecting and continuing to cooperate. (The discount rate is critical because the decision balances current benefits to defection against future costs.) If the actual discount rate is above this value blocs defect from free trade; thus, if integration (moving from smaller to larger blocs) reduces the critical discount rate, it makes cooperation less likely to be maintained.

Two countervailing forces exist as we consider larger blocs: the incentive to deviate is greater the larger are the blocs, but so too is the welfare loss in the resulting trade war. Bond and Syropoulos find that the former effect dominates, making it more difficult to maintain free trade in a bloc-ridden world. They also find that for any given discount rate the minimum supportable cooperative tariff rises as bloc size increases, also suggesting that integration increases the pressures for protectionism. Bagwell and Staiger (1993a, b) reach a



similar conclusion in a somewhat similar fashion, although only in the context of a temporary transition phase.

The discount rate is crucial to the assessment of trigger strategies because it trades off the immediate benefits of defection against the eventual costs of trade war. This raises the question of the time scale over which these games are played. In terms of individual tariffs and tariff wars--e.g., the occasional EC-US spats such as the Chicken War and the tussle over public procurement in early 1993--the period required for retaliation is so short that there are hardly gains to defection. Thus discipline seems virtually complete and the model suggests that nothing much affects the cooperative outcome. (This may change if finite rather than infinite periods of punishment were permitted, whereupon the main question would become what determines the punishment period.) If, on the other hand, we view this as a game in regimes, so that the GATT rounds represent the natural periodicity, and policies such as Super 301, the zeal with which antidumping policies are applied and the use of health and technical regulations become the weapons, the periods required to recognize defection and retaliate become much more meaningful. I find the latter interpretation more plausible: namely that the important effect of integration is not on the "tactics" of trade policy, but on the "strategy;" in some sense it tends to reduce the incentive to take a world view. In this regard I find the EC's concern with the volume of intra-EC trade as an indicator of the success of integration disturbing--see, for example, Jacquemin and Sapir (1988).

Campa and Sorenson (1996) apply the repeated game model of tariff-setting to something like Nordstrom's (1995) problem, and with similar results. In part they consider a hegemon facing a competitive fringe of small countries, and conclude that if the latter coordinate they might offset the former's market power and move the world towards freer trade. Of course, if the (ex-) fringe were too large it might become hegemonic in which case it would dominate the original one. In a second, symmetric, exercise they conclude that, as the number of blocs falls, the probability of free trade falls (i.e., the critical discount rate falls), but that equi-sized blocks are preferable (more likely to be liberal) than disparate-sized ones.

In a specifically EU application Bond, Syropoulos and Winters (1996) use the Bond and Syropoulos framework to consider explicitly the deepening of an existing regional arrangement. They consider a world of  $N$  symmetric provinces split initially into one large country (the United States) and two smaller ones (France and Germany); the latter have already combined into a bloc (the EU) with a common external tariff that is the result of a self-sustaining agreement between the EU and the United States. They then allow the latter pair to integrate more deeply by reducing trade frictions between them and ask whether tariff cuts within the union affect the incentive-compatibility of agreements with the outside country. It turns out that the Kemp-Wan tariff reduction--the reduction in the union's external tariff that just leaves the outside country indifferent to the internal tariff reduction--is a useful benchmark for this.

For the outside country, the reduction in the union's internal tariffs reduces the attractiveness of an initial trade agreement because its trade with the union is reduced. The Kemp-Wan reduction in the union's external tariff, however, will just restore incentive compatibility for the outside country because it restores to their initial levels both its welfare under the agreement and its incentive to violate it. For the union, a Kemp-Wan adjustment generates two conflicting forces. First, the initial trade agreement becomes more attractive to union members because the expanded volume of intra-union trade raises the welfare of member countries at the initial level of the external tariff. This suggests that the union could "live with" a lower tariff on the outside country. On the other hand, deviating from the agreement also becomes more attractive because the payoff to cheating also rises. This suggests that the external tariff needs to rise in order to keep the union in the agreement. (A higher tariff makes sticking to the agreement more attractive.) The first effect almost always dominates the second, so that incentive-compatibility is consistent with a fall in the union's external tariff.

To be more precise, the two forces on the union exactly offset each other if the share of union expenditure on union goods is invariant with respect to the external tariff. In that case, since the Kemp-Wan tariff reduction is incentive-compatible for both the union and the outside country, internal liberalization plus a Kemp-Wan reduction will generate a new sustainable agreement. Of course, many other agreements will also be sustainable, so there is no guarantee that the Kemp-Wan reduction in the external tariff will actually be chosen, but at least for one simple representation of the negotiating process Bond, Syropoulos and Winters show that it will be.

If the share of union expenditure on union goods rises as the external tariff rises (heuristically, if demand is elastic) the Kemp-Wan tariff reduction is not incentive-compatible for the union: that is, if the original agreement was just sustainable, internal liberalization plus a Kemp-Wan reduction will leave the union preferring to defect than to cooperate. As a result, the union, while likely to reduce its external tariff somewhat, will not be prepared to go as far as the Kemp-Wan reduction. Since the latter is necessary to keep the outside country at its initial level of welfare, the presumption is that, under these circumstances, the outside country will suffer from the union's internal liberalization. This illustrates the dilemma of defining multilateralism starkly. By reducing all tariffs in the model we have presumably enhanced multilateralism, and yet the RoW--the intended beneficiary of multilateralism--suffers a decline in welfare.

Somewhat similarly to Bond, Syropoulos and Winters, Bagwell and Staiger (1996) analyze a three-country model in a repeated game context. They assume two countries are patient ( $A$  and  $B$ )--and hence are happy with low tariff equilibria--while the third ( $C$ ) is very impatient. Under mfn rules  $A$  and  $B$  offer  $C$  lower tariffs than it reciprocates with because they wish to have low tariffs on their mutual trade. How is this affected if they sign a free trade agreement? Under such an eventuality the import sourcing condition suggests further reducing  $A$ 's and  $B$ 's tariffs on  $C$ , but, pushing in the opposite direction, the same condition suggests that  $A$  and  $B$  are likely to impose less harsh punishment on  $C$  if it defects, and  $A$ 's and  $B$ 's mutual tariffs are no longer dependent on their tariff on  $C$ . The net effect is ambiguous, but Bagwell and Staiger show that if  $C$  is very impatient and  $A$  and  $B$  very

patient it could entail higher tariffs on  $C$ . This is more likely if  $A$  and  $B$  form a CU rather than a free trade area because, being larger, a CU is less interested in freer trade.

Bagwell and Staiger's model is quite special because it assumes that, out of three goods, each country imports one from both partners while exporting both others, one to each partner. Its real significance, however, is to highlight the sensible proposition that if we ask "how useful is regionalism" part of the answer must be "that depends on how well the mfn rule was doing initially."

Bond and Syropoulos introduce regional blocs exogenously--e.g., for political reasons--and ask how they disturb an existing equilibrium. Ludema (1996) asks a more sophisticated question: how does the possibility of creating a regional bloc affect the conduct of multilateral negotiations aimed at achieving free trade. He uses welfare-maximization as his objective function and considers a three-country multi-round two-step negotiation. In each negotiating round the first step is a multilateral offer and if this is rejected a bilateral one may be made. If this is rejected a new round is initiated. A very strong assumption is that international transfers of utility are feasible. This guarantees that negotiations will always eventually end up with global free trade--the only efficient solution--and because in these games (a) time is money (the discount rate is positive) and (b) information is complete, they actually get there straight away. Thus negotiation is only about distribution--every offer is "global free trade plus some vector of transfers."

In this context Ludema does not help us much on "regionalism vs. multilateralism," except to the extent that his results may condition attitudes towards whether to rewrite

Article XXIV to ban regional arrangements. Ludema considers two questions. First, how would a pre-existing regional bloc affect a multilateral negotiation. If it is an FTA, not very much, because an FTA does not constrain the partners' negotiations with outside countries. If it is a CU, however, the effect is stronger because a CU precludes independent negotiation. However, this effect is weakened if the partners are asymmetric because the partners' ideal policies vis-à-vis outsiders would differ. Ludema's second question is how the possibility of regionalism affects negotiations. If only FTAs are possible the multilateral outcome resembles that of three separate bilateral negotiations, whereas if only CUs are permitted the first-mover advantage for the country that can first propose a CU allows it a disproportionate share of world income. In Ludema's model this is randomly decided.

A model of negotiated tariffs in which the repeated game is only implicit is Bagwell and Staiger's (1997) contribution to this volume. This starts from the position that countries gear trade policy to their own ends--be they political, economic, or whatever--and that trade agreements (and the GATT) exist to internalize the effects that *A*'s policy has on *B*--specifically to internalize terms of trade effects. If mfn trade rules allow complete internalization, then countries can reach the efficiency frontier (defined over their own objectives, not the economics community's) and regional arrangements have nothing to add. If, on the other hand, mfn tariffs cannot yield efficiency or, say, they pose enforcement problems, regional arrangements may have a role to play. In these cases regionalism is (potentially) optimal; there is no question of building blocs or stumbling blocs unless we wish to challenge governments' objectives. This brings us neatly to the next group of models which recognize that governments are not always economic welfare maximizers.

### 3.4 Pressure groups and voters

I now move on to what might loosely be called political economy models of integration--those in which governments are driven by economic considerations but not merely the (unweighted) maximization of welfare/utility. In this section we take governments' objective functions as given and assume they are efficiently pursued. In the next we ask how the decision process itself--the institutions which determine government behavior--affect the outcome. Many of the political economy models have a lot in common with the models I have already surveyed, but I collect them into one section because their focus on political economy is their main distinguishing characteristic.

Much of the political economy modeling derives from Grossman and Helpman (1994, 1995).<sup>10</sup> They argued persuasively that lobbying influences governments less in terms of determining which of the two polar policy stances wins an election than in terms of what policies an incumbent or newly elected government will pursue--the market for influence. In general consumers find it hard to organize a lobby and so lobbying is dominated by producers, who organize along sectoral lines. This effectively gives profits additional weight in the government's objective function; they enter once in the traditional calculus of surpluses (consumer, producer and government revenue), and again as the source of lobbying funds which the government values in their own right. Thus moving into the realms of political economy effectively biases integration outcomes towards what producers desire.

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<sup>10</sup> See also Helpman (1995) for a summary.

Grossman and Helpman (1995) consider a negotiation between two governments that have suddenly been offered the chance of concluding an free trade area (FTA). That is they compare staying with mfn trade policy with creating mutual preferences. In certain circumstances they find that the latter is politically feasible, i.e., raises government “welfare” which depends on consumer and producer surpluses but with different weights. The FTA is feasible either if it enhances consumer welfare while producers are unable to lobby against it, or if it enhances the profits of well-organized producers who pass some of the benefit onto the government via lobbies. The latter possibility is malign for it makes likely precisely those FTAs which generate most trade diversion. Trade creation is a mixed blessing for a negotiating government: it generates surpluses for consumers at home and for exporters in the partner country, but reduces them for domestic import-competing producers; trade diversion, on the other hand, generates no such reduction in profits, and although it correspondingly generates no (or fewer) consumer gains that matters less to governments. If two such governments can swap trade diverting concessions, trade diversion is good politics even if it is bad economics. Grossman and Helpman do not consider whether their process continues to create superblocs, although if it were driven by diversion alone it would have to stop before it achieved the global coalition, because the last step in that direction would have only trade creation.

Krishna (1994) has an elegant stripped-down three-country version of Grossman and Helpman in which policy is determined solely by its effects on profits. He assumes imperfectly competitive markets that are segmented from each other. He replicates the Grossman-Helpman result that, considering two of the countries, the more trade diverting an



FTA between them, the stronger its backing and hence the more likely it is to come about.

He then shows that the backing for further multilateral liberalization with the third country is reduced. Included in this is the possibility that multilateral liberalization that was feasible before the FTA would cease to be so afterwards--i.e., that, if the world attempted to achieve the multilateral free trade it desired via regionalism, progress would stop at the intermediate stage.

Very simply, let a sector's profits be  $\pi_1$  under mfn tariffs,  $\pi_2$  under the FTA and  $\pi_3$  under global free trade. The gains from FTA ( $\pi_2 - \pi_1$ ) may be sufficient to allow successful lobbying for the FTA; similarly, if it were the only option, the gains from global liberalization ( $\pi_3 - \pi_1$ ) might also permit successful lobbying; the gains from moving from an FTA to free trade ( $\pi_3 - \pi_2$ ), however, may be insufficient to encourage lobbying for that step: they will certainly be smaller than ( $\pi_3 - \pi_1$ ) because  $\pi_2 > \pi_1$  if the FTA was formed, and they may actually be negative. Moreover, this "suspended liberalization" outcome is more likely the more trade diverting was the initial FTA. Krishna shows that it may not even be possible for producers in the outside country to bribe those in the partners to adopt global free trade. This is because much of the benefit of the latter is "wasted" on consumers.

Krishna's is a very simple model--which is one of its attractions--and clearly requires some generalization. However, it is rather convincing that regionalism may hinder multilateralism--"the good" preventing "the best"!

The second extension of Grossman and Helpman is Baldwin (1995). This model of "domino" regionalism has many countries each with a constant returns to scale (CRS)

(numeraire) sector and a differentiated product sector with capitalists who receive the rent.

Government objectives are a convex combination of worker and capitalist welfare, the latter being enhanced by their ability to lobby. Baldwin assumes that a bloc already exists and that this situation is an equilibrium in the sense that countries on the outside wish to remain so because the economic benefits of joining do not outweigh the non-economic costs. He then shocks this world by deepening integration within the bloc--“1992”--or by allowing one country’s desire for integration to increase--the United States in the 1980s. Each shock would increase the incentives for new members to join--starting with those that were previously just on the margin of joining--and as they do so the costs to others of remaining outside grow. This in turn attracts others and so on.

Baldwin notes that the process of enlargement could stop as soon as all remaining non-members have high enough objections to joining. It could also, of course, do so when existing members shut the door. Baldwin deals, in fact, only with the demand for membership. As a parable for the absorption of the EFTA countries into the EC following “1992”--its intended purpose--Baldwin’s explanation is admirable, but its generalization to other accessions looks less secure--think, for example, of Poland, Cyprus and Turkey.

Given that deepening integration is bad for excluded countries--see above--Baldwin does not actually need political economy to generate his results, but it does help to explain some of the facts of political activity that surrounded the EFTA accession. Overall, however, the implications of all this for multilateralism are quite unclear.

An early contribution to the theory of endogenous protection and integration is Richardson (1993, 1995). Like Baldwin, Richardson's basic insight does not require a political economy dimension--welfare maximization would suffice. Suppose one country creates an FTA with a large partner (with a horizontal supply curve) and suppose that for certain imported goods the FTA is trade diverting because  $p_p < p_w (1+t)$  where  $p_p$  is the partner's price,  $p_w$  is the world price and  $t$  the mfn tariff. Domestic firms and consumers now face  $p_p$  instead of  $p_w (1+t)$ , but the government loses tariff revenue. A rational government would now reduce its mfn tariff to just below  $t'$ , where  $p_w (1+t') = p_p$ . This would leave domestic residents unaffected relative to the FTA but generate tariff revenue. The main constraint on this behavior is the reaction of the partner country which loses the rents it expected under the FTA. But if it is large and has other objectives in the integration, it might acquiesce. A reservation to this elegant model is the extent to which tariff revenues really motivate trade policy--the prevalence of VERs casts some doubt on this.

Political economy considerations support the rational outcome in Richardson's model. The initial reduction in the domestic price would probably reduce the size of the lobby for tariffs on the goods concerned,<sup>11</sup> and, besides, no one in the lobby has any interest in whether they are hurt by partner imports rather than non-partner imports. Richardson's results seem to require that partner and non-partner imports are perfect substitutes with fixed prices. If import supply curves slope upwards and/or the imports (and the home good) are imperfect substitutes in demand, then free access for the partner could well increase the demand for protection against non-members and this may outweigh the government's

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<sup>11</sup> This point is also made by McCulloch and Petri (1994).

revenue concerns. The necessary condition for this to occur seems to be that imports are drawn from both sources after integration.

Two contributions offer significant generalizations of Richardson's work. Cadot, de Melo and Olarreaga (1996) have a three-country model with Grossman-Helpman lobbying for influence by the fixed factors in each of the three industries. They ask what  $A/B$  integration does to protection against  $C$ 's exports and focus carefully on different types of integration. They find that if  $A$  and  $B$  create an FTA without rules of origin, protection is likely to fall, essentially for the reasons identified by Richardson. If there are rules of origin, however, the protective effects of the FTA are more complex and it is possible that either  $A$  or  $B$  will increase protection above either of the pair's pre-integration tariffs. Similar outcomes are also possible under customs unions. The reason is that in this model tariffs on different goods are substitutes: if one is reduced (by FTA membership), others rise (on  $C$ ). This is because the disprotected sector contracts, increasing the sizes and reducing the lobbying costs of the other sectors.<sup>12</sup> Cadot, de Melo and Olarreaga do not consider how  $C$  reacts to integration--it always offers free trade--but the propensity of the bloc members to raise their tariffs is likely to move us away from multilateralism.

The second generalization of Richardson is Levy (1996b--preliminary) who considers many countries in a model that also includes lobbying for influence and negotiated tariffs. He focuses on two major countries negotiating with each other and asks how this negotiation is affected if each acquires (exogenously) a fringe of FTA partners. Each country

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<sup>12</sup> Similar causal channels are found in Panagariya and Findlay (1994)

has effective lobbying in one import-competing (“sensitive”) sector; export interests aim to reduce the other country’s tariff in its “sensitive” sector by inducing reductions in their own country’s. The existence of the fringe affects the extent to which trade policy changes translate into increases in profits in the major powers. For example, suppose  $A$ ’s fringe can supply  $A$ ’s export good along a fairly elastic supply curve.  $A$  now has less interest in inducing  $B$  to reduce its tariff on these goods because part of the benefit spills over onto  $A$ ’s fringe’s suppliers so that  $A$ ’s own producers get a smaller increase in price.<sup>13</sup> Levy shows that considering both countries’ fringes these effects could go in any direction, so that giving major negotiating powers FTA fringes could either increase or reduce tariffs on their mutual trade. Thus if it is the major powers that determine the progress of multinational negotiations (e.g., the United States and EU in the Uruguay Round) Levy’s model suggests we cannot necessarily be sanguine about the EU association agreements, APEC and NAFTA.

I turn now to models with slightly different pressure group technologies. Richardson and Desruelle (1994) use a model with features of both Krishna’s and Baldwin’s to explain the height of EC-countries’ tariffs before and after integration: they have three countries and an economic specification like Baldwin’s except that they explicitly consider the distribution of tariff revenues. In addition they allow both workers and capitalists (now a single group) to lobby. Richardson and Desruelle compare Nash tariffs before and after the creation of a

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<sup>13</sup> The analysis revolves around the elasticities with which the fringe demands and supplies sensitive products, not its excess supply *per se*. Presumably the latter would enter the decision to create the FTA in the first place. The link with Richardson (1993) is best seen on the import analogue of the argument in the text. If the fringe supply curve of the sensitive import is perfectly elastic, the lobbies in  $A$  lose all interest in maintaining a higher post-tariff price on  $B$ .

customs union, assuming that the partners of the latter are identical.<sup>14</sup> Integration does not affect the relative weights of workers and capitalists in the formation of trade policy. The partners both export the differentiated good to each other and the excluded country, while the latter exports the CRS good.

It turns out that integration could push the external tariff (on imports of the CRS good) either way in Richardson and Desruelle's model. Generally it will raise it: before integration each partner moderates its desire to tax the CRS good because doing so will increase its costs in the differentiated sector with a resultant loss of sales and rents to the other partner. A customs union internalizes this spillover and hence allows a higher price. The counter-example occurs when workers determine the tariff but receive little of the revenue. Before integration they drive the tariff very high because they have no interest in the rents of the differentiated sector but do benefit from the Stolper-Samuelson effect on real wages. But this spills over to the other partners in terms of higher costs and prices of differentiated goods. Under the customs union this spillover is recognized and the tariff on the CRS good falls to the revenue-maximizing level. Overall, Richardson and Desruelle's results seem to suggest that RIAs increase trade restriction, for the starting point of their counter-case--very high tariffs on the CRS good--does not accord very closely with reality.

Levy (1994) continues (implicitly) with labor and capital and explores the stepping stones argument with a median voter model. He reaches similar conclusions to Krishna. The median voter's response to the offer of a trade policy change depends on his labor-capital

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<sup>14</sup> They still gain from integration because of the differentiated goods.

ratio and the labor-capital ratio of the trading blocs to which he belongs before and after the change. An important restriction is that voters first consider autarky versus a bilateral deal and then whatever they choose first versus multilateralism. This allows Levy to show that in a simple Heckscher-Ohlin model one does not get stuck at the bilateral stage.

Suppose  $A$  and  $B$  consider forming a bloc and that  $k^A < k^{AB} < k^B$  where  $k^i$  is the capital-labor ratio of country  $i$  and  $k^{AB}$  that of  $A$  and  $B$  combined. The median voter in  $A$  will agree to the FTA if increasing his economy's  $k$  is beneficial to him and the median voter in  $B$  will approve if he gains from a decrease. Suppose both approve and that we then pose the second question which would produce a world economy with ratio  $k^w$ . If  $k^w > k^{AB}$  voter  $A$  will favor multilateralism. Voter  $B$  might also if  $k^w$  far exceeds  $k^{AB}$ , but more likely he will reject it, leaving the world stuck in bilateral mode. But voter  $A$  can foresee this and would therefore veto bilateralism at the first stage relying on the second ballot--which would then become autarky vs. multilateralism--to achieve his goals. Essentially no two countries that favored multilateralism initially can create an FTA, so the world is safe!

Now Levy adds variety effects so that the median voter receives utility not just from his real income but also from increased variety. This can cause a breakdown at the intermediate stage. Suppose the median voter is only just in favor of multilateralism, balancing increased variety against disadvantageous price/wage effects. If the FTA offers disproportionate gains it could push the voter's utility above the multilateral level. For example, if  $A$  and  $B$  have identical capital-labor ratios  $k^A = k^{AB} = k^B$  there are no price wage effects but there are variety effects. These could leave the median voter better off and

resisting the move to multilateralism, even though the latter would have been chosen relative to autarky. It is FTAs between similar countries that pose the greatest threats to multilateralism, those between dissimilar ones that pose the least. This suggests that the current rash of North-South arrangements, such as NAFTA and the EU Association Agreements, are not likely to be very harmful. However, subsequent work--Levy (1996b), see above--rebuts this presumption.

Frankel and Wei (1996) offer a counter-example to Levy's argument that bilateralism can never increase support for multilateralism. They do so in a Ricardian world with costs of adjustment for workers changing sectors. There are three countries ( $A$ ,  $B$  and  $C$ ) each with comparative advantage in one of three goods ( $a$ ,  $b$  and  $c$ , respectively); in each of two potential partner countries ( $A$  and  $B$ ) workers are spread over the three sectors such that none has a majority. If workers focus on the costs of adjustment a majority in  $A$  will oppose multilateral liberalization (those in  $b$  and  $c$ ), but favor bilateral liberalization (those in  $a$  and  $c$ , who will benefit from the falling price of  $b$ ). If the bilateral bloc is formed workers will have to move--perhaps all  $b$ -workers move to  $a$ . Now there will be a majority in favor of opening up with  $C$  as well.

Frankel and Wei's argument relies either on workers not realizing that the multilateral vote will follow the bilateral one (otherwise  $c$  workers would oppose bilateralism) or on voters believing that the following voting structure will be used regardless of outcomes: vote first on an  $A/B$  bloc and then, whatever the outcome, vote on opening up to  $C$ . In the latter case  $c$ -workers cannot avoid liberalization and so would go



along with the *A/B* bloc. The latter seems implausible to me, but not the former given the uncertainties and glacial pace of trade diplomacy. It also seems fairly plausible that voters do focus on adjustment costs. Almost any discussion of trade liberalization with policy-makers takes about ten minutes to get around to unemployment. Thus contrary to Levy's (1996a) comments on this paper, it seems to me a plausible counter-example, albeit one which is far from categorical, for the voting weights could easily generate alternative outcomes.

General conclusions from the political economy literature are elusive. One such conclusion is that the dominance of sector-based lobbies over economy-wide ones (factor-based or consumer) makes trade diversion more attractive to policy-makers, for trade diversion shifts rents and/or activity towards producers. While one cannot be categorical, this tendency seems likely to gravitate away from multilateralism for trade diversion is possible only from preferential arrangements. The tendency is manifest first in the notion that integration beyond a trade-deflecting FTA may induce higher tariffs on the rest of the world, and, second, in the more interesting observation, that one might get stopped on a regional stepping stone before achieving free trade. While there are counter-examples I find the broad thrust of this argument convincing.

### **3.5 Institutional arrangements for regional blocs**

The discussion in Section 3.4 presupposed that all the features of a regional bloc are fully determined at its onset--implicitly in the negotiation phase during which national governments, pressure groups and voter interests are identifiable and distinct. For FTAs this

seems a reasonable assumption, for, other than maintaining mutual free trade, governments are quite unconstrained by an FTA. Even for an FTA, however, it would be worth asking--rather along the lines of Levy (1996b)--how the existence of an FTA conditions governments' reactions to exogenous shocks. For example, if the price of a major exportable falls will governments be more likely to resort to protection with or without an FTA? Bhagwati and Panagariya (1996) have suggested that being in NAFTA made the Mexican government's response to the 1994/5 crisis less liberal than if it had been unencumbered: the previous mid-80s crisis eventually led to thorough-going liberalization whereas the mid-90s crisis produced tariff increases on some non-NAFTA imports. Most other commentators have argued that since the response in the mid-80s was initially very protectionist, NAFTA appears to have constrained behavior to be moderately liberal. While the literature surveyed so far sheds some light on these issues by asking whether an FTA increases propensities to protectionism, it does not address it directly because it does not really consider how FTA members take decisions.

If consideration of this issue is desirable for FTAs it is indispensable for customs unions and deeper forms of integration. One might determine the initial common external tariff in the negotiation phase, but thereafter one needs mechanisms for deciding how to change it either in multilateral negotiations or ad hoc via anti-dumping actions, etc. How one does this--how one aggregates preferences across members--is likely to be very important in determining the outcomes. This problem does not arise in models of welfare-maximizing governments where members are symmetric, for one maximizes the representative country's welfare. Thus it is essentially a problem of asymmetry and politics.

One interesting aspect of joint decision-making concerns how formerly national lobbies interact to bring pressure to bear on the customs union authorities. The only formal analyses of this question all suggest that interest group pressure is diluted by the customs union. The essential point is that it costs more to lobby for a 1% increase in your tariff in a customs union than in a constituent member country with the right to set its own tariffs: there is more opposition to overcome (Panagariya and Findlay, 1994, de Melo, Panagariya and Rodrik, 1993) or more representatives to influence (Richardson, 1994). Given the lower returns less lobbying occurs and the sum of the members' lobbying activity falls as a result of integration. This can equivalently be viewed as a public good problem, for a common external tariff is a public good: the lobby from *A* does not wish to devote resources to lobbying for protection for producers in country *B*. Whether the resulting tariff is lower than that which would rule in all member countries in the absence of integration is unclear, however, and so one might be trading less protection in some members for more in others. Whether this enhances multilateralism clearly depends on precisely how you trade off breadth against depth in the external tariff.

All these models presuppose that lobbies in different member countries will oppose each other, but it is also possible that some of them have their power enhanced through integration (Winters, 1993). For example, anti-protectionist forces might also be diluted by the free-riding problem. Alternatively each member state might initially start with a lobbying game in which industry and agriculture more or less cancel each other out, but if integration lets the agriculture lobbies cooperate (because they produce the same things) while the industry lobbies compete (because they produce different things) the union may

end up with high agricultural protection. Overall, therefore, while dilution effects will undoubtedly be present, it is not proven that they will always predominate.

I turn now to the organization of government. Gatsios and Karp (1991, 1995) show that it might matter which member state “leads” negotiations with the rest of the world on a particular issue. In their model, if a more aggressive member determines the union’s position, the union is able to extract a more favorable deal from RoW than if the “average” member does so. This is because the former is more credible in its threats to retaliate (with the whole of the union’s resources). In this model, “passive” members could benefit from delegating power for certain policies to aggressive ones, because, although for any given RoW policy they would prefer a less aggressive union stance, the RoW is so much more accommodating under the delegation that they are better off overall. What about multilateralism? That depends on whether a more aggressive union can achieve a more liberal outcome with the RoW by virtue of its readiness to retaliate, or whether it actually needs to use its muscle. Gatsios and Karp’s model deals with this essentially only by assumption.

The formal delegation of the power to settle negotiating positions is of limited relevance in real customs unions, but informal and partial delegation clearly exists. It has commonly been observed (e.g., Winters, 1993) that the EU allows countries disproportionate influence over policy in areas in which they claim vital interests, allowing them, in extremis, veto power. Given that for all the reasons noted above a country’s “interest” in a sector is commonly correlated with that sector’s share of its GDP, it is easy to imagine this feature

enhancing further the interests of producers. What effect this has on the union's trade policy depends on whether a sector's having a high share of a member's GDP reflects its comparative advantage or past policy distortions. If the former, one might expect relatively liberal stances,<sup>15</sup> whereas if the latter, protection will be more strongly favored. One encouraging aspect of this is that since integration will tend to relocate union production in a sector towards relatively more efficient countries, over time this argument could lead to reduction in protectionist pressure.

Winters (1994, 1995) considers the institutional basis of decision-making more closely, and, in an EU context, observes several features that could lead to protectionist biases in the aggregation of preferences. If the union is essentially inter-governmental, rather than democratic in its own right, policy will be made by groups of bureaucrats and, eventually, ministers representing their own governments. This can be protectionist, first because, as Messerlin (1983) notes, the incentives for bureaucrats tend towards protectionism, and, second, because as Scharpf (1988) notes, adding layers of inter-governmental decision-making tends to swing influence away from voters and towards official preferences for administrative convenience and a quiet life. The secrecy that surrounds EU deliberations reinforces these tendencies because it confuses public perceptions of where the responsibility for trade policy outcomes actually lies.

Within the EU, trade policy is essentially made by committee--the so-called "113 Committee"--the members of which represent particular constituencies (countries) and none

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<sup>15</sup> Such a sector may prefer high EU protection, so that it can reap high rents on EU sales, but at least it could survive with lower protection.

of whom is publicly accountable for the final outcome. This gives rise to at least two (related) failures of aggregation. First, the restaurant bill problem: suppose the benefits of a policy on product  $j$  to a country  $i$  are proportionate to the latter's share of union output ( $x_{ij}$ ) and the costs to its share of GDP ( $g_i$ ), and suppose that each country has a veto, or at least that consensus is valued very highly. If representatives sit down to decide a package of policies on  $j=1, \dots, N$  products, each will press for inclusion of any good for which  $x_{ij} > a g_i$ , where  $a > 1$  reflects the inefficiency of the conversion of costs into benefits. Since each is highly likely to have some  $j$  for which this is true and, provided the perceived  $a$  is not too large, the easiest package to construct will cover nearly all products even if, overall, each country would prefer no change to the final outcome.

The second failure is similar but operates in probability space--see Shepsle and Weingast (1981), who christened the phenomenon "universalism," Schattschneider (1935) on the Smoot-Hawley tariff, and Winters (1994) on the EU. Imagine that protecting footwear is being discussed and that each of three member states is a producer of one type. If any one type is protected, the government in whose country it is produced perceives benefits of  $c$  (surplus to producers, political convenience etc.) and each member bears cost of  $-(c+d)/3$ , where  $d (>0)$  is the deadweight cost of transferring  $c$  through protection. Net costs are zero if the measure is rejected. The issue is to be decided by simple majority, and each member must decide how to vote; each accepts that if it votes against the measure, its type of footwear will not be protected.

Table 1 reports the costs and benefits of the proposal passing according to whether a member votes 'for/in' or 'no/out.' It also reports the probability of the proposal passing, assuming that the other countries vote randomly with probability one half each way. The expected value of voting 'for/in' is  $0.5*[c-2(c+d)/3] + 0.25*[c-(c+d)]$  ( $\geq 0$ ), while that of voting 'no/out' is  $-0.25*2(c+d)/3$  ( $< 0$ ). Thus a government will vote 'for/in' if  $4c > 5d$ --i.e., if its 'benefits' from the protection exceed the deadweight loss by 25% or more--and even if it expects negative returns to doing so!

A more sophisticated view of voting for trade policy in the EU is offered by Widgren (1995a, b) drawing on Hamilton (1991). Widgren notes that small countries have disproportionate numbers of votes; he considers voting coalitions and calculates countries' voting power in terms of the frequency with which they might command a pivotal position in the EU's qualified majority voting system. He argues that if we contrast liberals (the Netherlands, Luxembourg, Germany, Denmark, Belgium and the United Kingdom) with protectionists (Spain, Portugal, Italy and France) with Ireland and Greece as uncertain, no group has power in a deterministic sense (each has a blocking minority). The EFTA enlargement does not change this and so changes to the status quo look unlikely. However, allowing for probabilistic voting, with the probabilities being the same for each member of each group but varying by group, change is possible most probably in a protectionist direction: the power of the two groups is roughly balanced over proposals covering the whole range of restrictiveness (as measured by the probability of receiving support from the liberals), but in the more protective range the protectionists appear to muster rather greater

Table 1 The universalist argument: Costs and benefits for a single country if the measure passes

Total number of countries voting 'for/in'	2	3
Cost	$-2(c+d)/3$	$-(c+d)$
This country votes 'in'		
benefit	$c$	$c$
probability of measure passing	0.5	0.25
This country votes 'out'		
probability of measure passing	0.25	0



power and thus are more likely to get their way. Widgren's work clearly depends on particular constitutional structure, but it illustrates how voting patterns may generate aggregation biases. Given that in the post-war period liberalism has required positive action, the EU system favoring the status quo is not particularly multilateral.

#### **4. What the Evidence Suggests**

This section briefly surveys the evidence on "regionalism vs. multilateralism." Regrettably it seems to be as ambiguous as the theory, at least so far as issues of current policy are concerned. As noted above, among current RIAs only the EU is large enough and long-lived enough to have had identifiable consequences on the world trading system itself, and it is more or less impossible to sort out what is generic and what specific among the lessons it teaches. Perhaps the only unambiguous lesson is that the creation of one regional bloc does not necessarily lead to the immediate break down of the trading system.

Several fundamental problems confront the scholar in this area. Foremost is creating an *anti-monde*--how can we know what member countries' trade policy would have been in the absence of the RIA? Second, systems evolve over long periods of time; it is not inconceivable that while post-war RIAs have been liberal so far, they are sowing the seeds of destruction, for example by reducing the number of independent middle-sized states which have an interest in maintaining the world system. Third, as noted above, trade policy responds to shocks from other areas: RIAs may be benign under one set of circumstances, but not another. How, then, do we allocate responsibility over causes. Fourth, how do we define and measure multilateralism? Fifth, the rhetoric required to achieve a political

objective does not necessarily reflect actual causes. Even if policy-makers say they are responding to an instance of regional integration--e.g., in raising a tariff or seeking a multilateral negotiation--how do we know this is the real cause?

One solution to these difficulties is to dispense with looking at the evidence altogether on the grounds that nothing concrete can emerge. I prefer an alternative view: as long as we are frank about the degree of confidence we can have in various conclusions, it is better to consider actual cases than to ignore them.

#### **4.1 Members' own trade policies**

The evidence on whether the EU has led to higher or lower tariffs and non-tariff barriers for member states' non-partner trade continues to defy simple conclusions. Hufbauer (1990) argues that it created the conditions for France and Italy to contemplate liberalization and that Germany would not have proceeded without its continental partners. Messerlin (1992) agrees that the EEC aided French liberalization indirectly by creating the appropriate macroeconomic environment. *Prima facie* these views of France do seem plausible, for she has always appeared a reluctant liberalizer. On the other hand, crises and sudden perceptions that one is getting left behind can have dramatic effects: France's switch in the early 1980s from Keynesian expansionism to fiscal orthodoxy arose precisely because the former failed to work. A similar "road to Damascus" could also have affected a highly protectionist France in a more liberal continent--consider Mexico in the mid-1980s, for example. Hufbauer, it seems to me, may well be wrong about Germany: in each of the two years prior to the creation of the EEC, Germany undertook tariff cuts of 25% (Irwin, 1995).

Thus not only did the tariff averaging attending the creation of the EEC raise German tariffs, it also possibly curtailed a liberalizing momentum.

No-one, I suspect, would argue that the EU has set external tariffs above the levels that would otherwise have ruled in at least one of its member countries, but this is quite different from arguing that it has not raised protection in some countries and sectors--e.g., footwear in Germany, agriculture in the United Kingdom, and textiles and clothing in Sweden. The trade-off between the breadth and depth of protection is not well defined and so we cannot satisfactorily rule on whether these examples constitute increases or decreases in multilateralism.

Other recent evidence on countries' own trade is equally mixed. Following NAFTA, Canada reduced tariffs on 1,500 tariff items (mostly inputs) to help her industry compete with the United States where tariffs were lower (WTO, 1995). This looks similar to Richardson's tariff competition. On the other hand Mexico increased tariffs on 500 items--see above. In Mercosur, Argentina's tariffs on capital goods' imports will be raised to Brazilian levels.

Going back further in time, the 1960s RIAs in Latin America were inward-looking and frequently maintained and even raised barriers against the RoW. The Central American Common Market, for example, generated huge growth in intra-trade behind such barriers (Nogues and Quintanilla, 1993). In all probability the import-substitution policy would have been less broad and/or foundered sooner if it had been restricted to small countries operating on an mfn basis. Even further back, in the 1930s, one also finds high external tariffs and

burgeoning regionalism, but here the evidence is probably more favorable to regionalism--Oye (1992) and Irwin (1993). Trade barriers were going up anyway and regional arrangements probably served to reduce the coverage of the increases by exempting some flows.

#### **4.2 Other countries' policies**

When one thinks of the effects of regionalism on the multilateral system one is obliged to deal with interactions between countries. How does an RIA cause other countries to respond? WTO (1995) suggests three classes of response: to seek to join an existing group; to create a new group; and to seek multilateral liberalization.

The observation that regional arrangements have recently attracted new members is commonplace; one need not even list examples. However, whether this is good or bad for multilateralism is moot, for we are clearly far away from achieving a global coalition. Moreover, accretion is not inevitable and irreversible. Countries do leave groups--e.g., Chile and Peru effectively left the Andean Pact, although admittedly after it had become rather rigid. In both cases, multilateralism benefited from the defections.

The second option, of creating new RIAs, also looks popular according to the evidence. Regionalism has proceeded in waves--the 1960s and the later 1980s and 1990s--and policy makers variously refer to demonstration effects, to the need to create their own market areas in case other blocs turn inwards, and the desire to create bargaining power. Examples include the establishment of EFTA, and recent discussions surrounding AFTA

(Asean Free Trade Area) and the CBI (Cross-Border Initiative in Africa). Again, of course, it is moot whether this enhances or undermines multilateralism.

Finally, most directly relevant and most contentious, many commentators argue that excluded countries will seek multilateral liberalizations in response to RIAs. This occurs mainly in the realms of super-power trade diplomacy, because only super-powers can manipulate the multilateral system but even smaller powers may warm towards multilateral talks if they perceive a fragmenting world economy. Arguments of this sort have been made about each of the last four GATT Rounds as well as in certain earlier instances.

Many commentators have argued that the creation of the EEC led directly to the Dillon and Kennedy Rounds as the United States sought to mitigate the former's trade diversionary consequences--see, for example, Lawrence (1991), Sapir (1993) and WTO (1995). I have expressed some reservations about this linkage--Winters (1993, 1994). I do not deny some connection between these events, but I am still concerned that we have not established a necessary link between them, that any such link was benign, or that it is generalizable to other instances of integration.

First, it seems implausible to argue that multilateral progress would have stopped had the EEC not been created. After all, the benefits of liberalization are not much affected by other countries' regionalism, it is just that, following the creation of an RIA, multilateral liberalization may be necessary to avoid actual harm to excluded countries. The United States still had considerable hegemonic power in the late 1950s and early 1960s and so could probably have generated enough support for a Round whenever it wanted. It is not generally

maintained that the EEC made the Europeans more willing to negotiate. Thus overall, I suspect that, at most, we are talking about the timing not the existence of the next Round.

Second, the Administration played the EEC card hard in public and in Congress. But whether they actually believed they had to respond to its creation and whether that creation was the major factor behind the push for talks is less clear. Recent debate in the United States about trade issues has sometimes demonstrated a disconnect between rhetoric and economic reality and so the EEC could just have been a convenient handle with which to maneuver US domestic interests and the EC nations into talks.

Third, since agriculture played such an important and delicate role in its formation, it is not surprising that the EEC resisted that sector's inclusion in the negotiations. But the fact that it got away with this (because the United States refused the "*montant de soutien*" offer) reinforced agricultural protectionism throughout the world and made it doubly difficult to negotiate in future rounds. Future agricultural disarmament may have been easier in the absence of the EEC.

Fourth, suppose it were true that the creation of the EEC forced the US Congress into trade talks. That would be tantamount to the aggressive unilateralism that many currently deplore in US trade policy. "The Six" would have done something to harm their partners, at least in the partners' eyes, and then mitigated it in return for concessions. This is a dangerous game, even if a successful one, and might be playable only a few times. Indeed, if it were the case, it could explain why US policy has become more belligerent towards the latest enlargement and towards "1992." However, in fact, the United States was generally

sympathetic towards EC integration and actually encouraged it by allowing the Administration to offer deeper tariff cuts to a European Customs Union than to the separate European nations--Jackson (1991).<sup>16</sup>

It has also been argued--although less frequently--that regionalism was behind the Tokyo Round. Winham (1986) reports both the first EEC enlargement (including free trade with EFTA) and the restrictiveness of the CAP as factors in the US view. The former observation seems no more compelling than those surrounding the creation of the EEC, while the latter is distinctly two-edged from our perspective: it requires, first, that the CAP induced negotiations and, second, that regionalism induced the CAP--i.e., that regionalism increased trade restrictions. Again, for this to be advantageous in its net effect on multilateralism requires a negotiating model in which might and countervailing power are the critical elements of liberalization, quite contrary to the hegemonic views of, say, Keohane (1984). It has also been suggested to me that enlargement finally achieved a US goal by bringing the four biggest economies of Europe into one bloc and that this required a commensurate foreign policy response. Maybe, but why this response took the form of initiating a trade negotiation in the face of European opposition is unclear.

Finally, consider the Uruguay Round. Its initiation has not been related to regionalism, but its completion has. WTO (1995) says "there is little doubt that ... the spread of regionalism [was a] major factor in eliciting the concessions needed to conclude"

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<sup>16</sup> Maybe this reflected US fears of the EEC--i.e., that it felt obliged to offer and to seek bigger tariff reductions if the EEC completed its integration--but publishing the fact seems a clumsy negotiating ploy if that were the case.

the Round. Frankel (1996) reports Fred Bergsten's conversation with German policy-makers in which it was stated that the APEC meeting in Vancouver was a major jolt to the EU which prompted it to reach settlement in the Round. On the WTO's general assertion there was a perception that the failure of the Round would lead to regional fragmentation, and this certainly encouraged the spread of defensive regionalism. How much pressure this put on the two major negotiating parties is not clear, however, for they would not have been the principal casualties of fragmentation. Bergsten's interlocutor seems to me (albeit from the outside) likely to have been confusing rhetoric and substance. The EU had set up the conditions for settlement in the MacSharry farm reforms in 1991/2 and some insiders report that as early as 1990 EU negotiators recognized that they would complete the Round as soon as they had built an appropriate domestic coalition on agriculture, e.g., Hathaway and Ingco (1996).

A common theme runs through all these accounts of regionalism and GATT multilateral rounds: the threat of (or, worse, actual) violence and response. All the accounts report countries running back to the multilateral system to counter the damage that other countries' RIAs may do them. This may be an effective way forward but it clearly relies on rather fine judgment by both (all) protagonists that folding is better than fighting. Perhaps if regionalism has raised the average de facto level of multilateralism it has done so at the expense of increasing the chances of catastrophe.

Earlier evidence on regionalism is somewhat more positive, but in different circumstances. Irwin (1993) reports how the Cobden-Chavalier Treaty spawned a rash of



mfn trade treaties and so created an era of significant liberalism (if not formal multilateralism). After about 1880, however, this began slowly to erode, not in a regional fashion but with mfn rates being increased. Nonetheless, the last quarter of the nineteenth century remained a reasonably liberal period. In the inter-war period the multilateral trading system fell apart very rapidly following the imposition of the (mfn) Smoot-Hawley tariff. Both Oye (1992) and Irwin (1993) argue that whereas multilateral attempts to halt and reverse the collapse failed, regional attempts induced a measure of liberalism. Britain, France and Germany sought to protect their export markets by preferential arrangements, and in so doing did violence to US exports. This in turn induced the United States to turn to bilateral approaches in the Reciprocal Trade Agreements Act of 1934.

I draw two lessons from these historical analyses. First, regionalism/bilateralism, which entails much more obvious pay-offs for exporters (internalization) than multilateralism, can help to break down restrictive regimes. Whether it can lead all the way to multilateral liberalism is not proven, but it clearly has the ability to start the process off. This is consistent with the observation that difficult issues such as public procurement, standards and services feature more strongly in regional than in multilateral arrangements. The challenge for the policy-makers is to establish a means of switching to the multilateral horse once the race has started.

Second, building on Oye's analysis of "shiftable externalities," potentially regionalized systems are likely to break down much more quickly than purely multilateral ones--cf the late 1800s and the 1930s. Shiftable externalities are externalities which an

action creates but whose incidence can be moved between other agents according to their actions. Suppose I import equally from five partners and want to cut my total imports by 20%. An mfn tariff increase might cut those from *A*, *B*, *C*, *D* and *E* each by 20%. But suppose *A* offers me a concession to exempt itself from the cut. The others now have to bear a 25% cut if I am to make the same target. Now suppose *B* wants to negotiate. It has to offer a bigger concession because it has to claw back a bigger cut in exports. And so on. There is a clear incentive for any supplier to strike an exclusionary deal and as quickly as possible. The possibility of regionalism increases the speed of decay.

Perhaps the crucial question is “where is the world economy now?” Fairly closed, so that regionalism is necessary (efficient) to crack open widespread barriers, or fairly open, so that the danger is that regionalism could precipitate a collapse if someone made a wrong call? Perhaps the answer differs by sector, so that while regional arrangements are important in new issues, they are a potential danger in areas such as goods trade.

## **5. Finale**

This section collects together the principal lessons from this survey both in terms of conclusions and directions for future research. Before doing so, however, it reports one final contribution to the literature that I have been unable to fit into the schema above.

### **5.1 Investment Not Trade**

Many commentators argue that the recent crop of North-South RIAs--e.g., NAFTA and the Europe Agreements--have been aimed at locking in the southern partner's economic

reforms and stimulating inflows of foreign direct investment (FDI). Ethier (1996) offers a brilliant formalization of these ideas. Briefly, developing countries start in autarchy, and as the world grows and liberalizes they start to think about opening up themselves. If they reform successfully and attract an inflow of FDI, they gain a step increase in productivity. Their problem is that if several of them reform simultaneously, none can guarantee that it will get the FDI--maybe the inflow will go to their rivals. Regionalism, by which an industrial country offers a particular developing country small preferences on its exports, overcomes this problem by ensuring that the industrial country will invest in its partner developing country rather than any other. (Since all industrial countries are assumed to be identical, as are all developing countries, the smallest preference on return exports stemming from an FDI flow is sufficient to create this link.) Thus regionalism ensures the success of reform, not only increasing the proportion of reforming developing countries that succeed but also encouraging more to try. This is regionalism as coordination--it removes a source of uncertainty and thus encourages reform and openness.

Ethier's paper is original and important, but its model is very special. In particular, there are no conceivable costs to regionalism to the partners, and, because countries are identical within their type-class, no dangers of inefficient regional arrangements growing up within the classes. Thus coordination comes essentially for free. Additionally, small changes to the model would allow the same coordination to be achieved multilaterally. For example, if each developing country considers coming out of the closet of autarchy at a unique time (because they all differ slightly from one another in dimensions that affect the timing of their reform decision), or if the supply of FDI for the industrial world is

sufficiently large or the movements of factor prices in developing countries sufficiently strong, every developing country can be sure of getting some FDI if it opens up. Nonetheless the focus on FDI rather than trade is a powerful attraction of this approach, given the structure of and rhetoric surrounding current North-South regional arrangements.

## **5.2 Conclusions and Future Research**

The issue of “regionalism vs. multilateralism” is new analytically and deficient of empirical evidence. It is hardly surprising, therefore that this survey should conclude with more statements about research strategy than about the world we live in. Indeed, as I noted above, the only categorical statement that can be made in the last class is that one incident of regionalism is not sufficient to undermine a relatively multilateral system immediately.

My main conclusions from working on this fascinating literature include:

- Since we value “multilateralism,” we had better work out what it means, and, if it means different things to different people, ensure that we identify the sense in which we are using the term when we do so.
- The symmetric models looking at the welfare effects of regionalism have served their purpose and probably offer rather little return to future research. Their structure is not plausible and their results seems very fragile with respect to assumed parameter values. If completely new ways of thinking about regionalism emerge, it may be worth

exploring them in a symmetric framework as a way of elucidating their properties, but this is not going to resolve the positive “stepping stones” question.

- Asymmetric models are more plausible, but it is important to model both the demand for and supply of bloc membership.
- Models of negotiated trade policy also take a significant step towards realism. However, it would be nice, in future, to try to move beyond the repeated game trigger strategies approach to model a richer set of objectives and disciplines. This, of course, is a challenge not only to researchers on regionalism, but also to those working on the trading system in general.
- Sector-specific lobbies are a danger if regionalism is permitted. Trade diversion is good politics even if it is bad economics. I find quite convincing the view that multilateral liberalism could stall because producers get most of what they seek from regional arrangements.
- The direct effect of regionalism on multilateralism is important, but possibly more so is the indirect effect it has by changing the ways in which (groups of) countries interact and respond to shocks in the world economy. The way in which the existence of fringes of small partners affects relations between large players seems to be a fruitful avenue, as does the structure of post-integration institutions.

- It would be useful to embed the “regionalism vs. multilateralism” question in a framework of general economic reform and/or economic growth to generate richer menus of potential benefits and chains of causation.
- Regionalism, by allowing stronger internalization of the gains from trade de-restriction, seems likely to be able to facilitate freer trade in highly restrictive circumstances or sectors.
- The possibility of regionalism probably increases the risks of catastrophe in the trade system. The incentives established by the insurance motive for joining regional arrangements and Oye’s analysis of “shiftable externalities” both lead to such a conclusion. So too does the view that regionalism is a means to bring trade partners to the multilateral negotiating table, because it is essentially coercive. The latter may have been an effective strategy, but it is risky.

## Appendix 1: An Index of Multilateralism?

A country's multilateralism index is a positive function of

- (a) the absence of discrimination in its trade policy
- (b) the closeness its trade regime is overall to free trade.

Assume that only one commodity is traded in the world and that our country imports it from every other country in an  $(N+1)$  country world. Assume also that initially all partners face the same (mfn) tariff at level  $t$  and that no other distortions exist. Suppose now that the country signs an FTA with some  $(n)$  partners. How do  $t$  and  $n$  enter the index of multilateralism ( $M$ )?

Figure A.1 plots contours of equal  $M$  in the space of the mfn tariff ( $t$ ) and the number of FTA partners ( $n$ ). Starting at, say,  $A$ , with a positive  $t$ , assume we sign an FTA with one partner. This increases discrimination and so would require a decrease in  $t$  to keep  $M$  constant; similarly if another partner entered the FTA,  $t$  would need to fall further. Thus the iso- $M$  curve would include a point like  $B$ . Eventually, however, say, at  $C$ , enough countries would be in the FTA that increasing  $n$  would, *ceteris paribus*, increase measured multilateralism, allowing an increase in  $t$  along the iso- $M$  curve. Now imagine the far end of the curve. When the final country gets into the FTA, our country offers everyone free trade and the mfn tariff can be infinity.

For any  $n$ ,  $n$  countries pay a tariff of zero, while  $(N-n)$  pay  $t$ . Since freer trade entails higher multilateralism, if, say,  $m$  countries are "exceptional ( $m < N/2$ ),"  $M$  will be higher if

the majority ( $N-m$ ) pay zero than if the minority ( $m$ ) does. Looked at alternatively, for many values of the tariff ( $t$ ), a given level of multilateralism ( $\bar{M}$ ) could arise with two different values of  $n$ , say  $n_1$  and  $n_2$ ,  $n_1 < n_2$ . We require that  $n_1 < (N-n_2)$ , as in figure A.1. Figure A.1 presents three such iso-multilateralism loci, with the degree of multilateralism increasing the closer the locus is to the  $\underline{x}$ -axis. In the limit the locus for perfect multilateralism runs along the  $\underline{x}$ -axis and up the vertical from  $N$ .

Clearly this index is quite complex and will become even more so once we recognize that more than two trade regimes might exist (in this example partners pay either  $t$  or  $0$ ) and that regimes will actually vary across commodities. It becomes even worse once we recognize that we need to aggregate across countries.

The conclusions of this appendix are twofold. First, we actually need to think what we mean by multilateralism if we think we are worried about it. Second, in the meantime our conclusions about regionalism vs. multilateralism will remain a little fuzzy.



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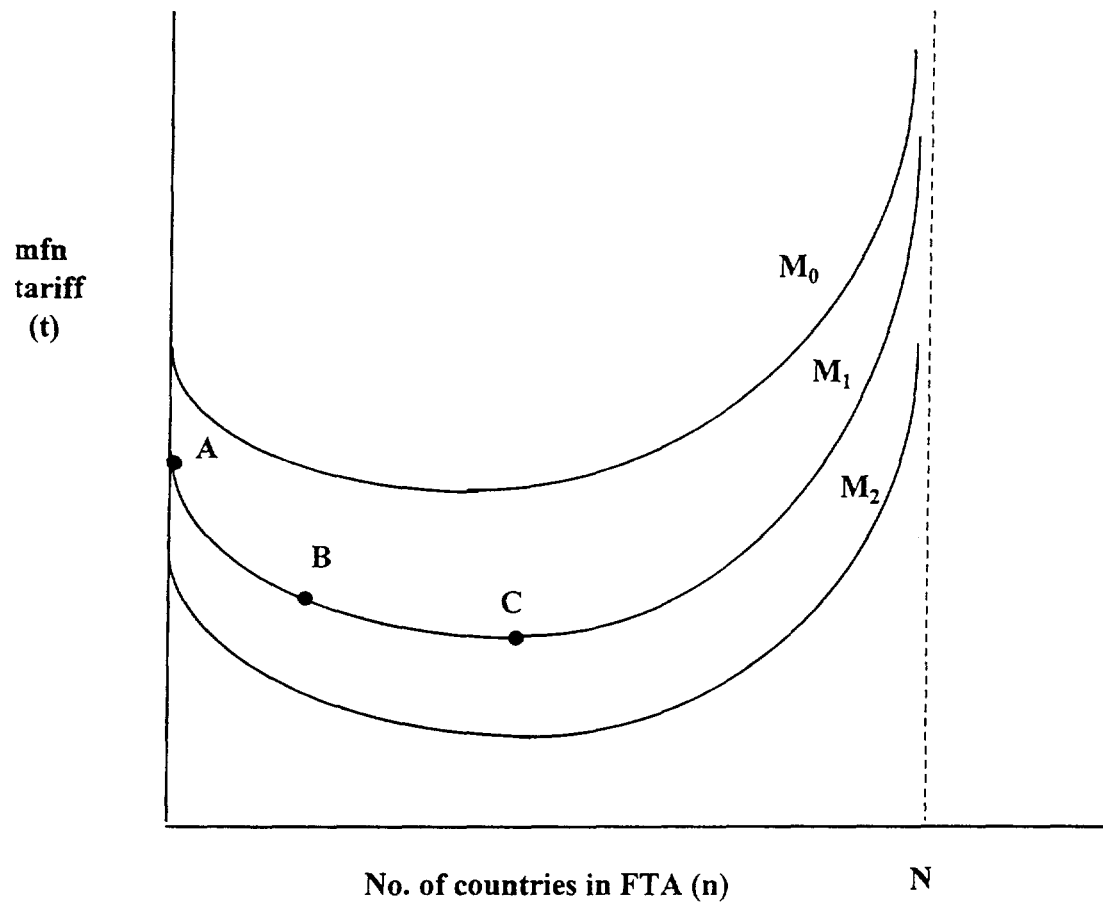
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Figure A.1 Iso-Multilateralism Loci ( $M_2 > M_1 > M_0$ )



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